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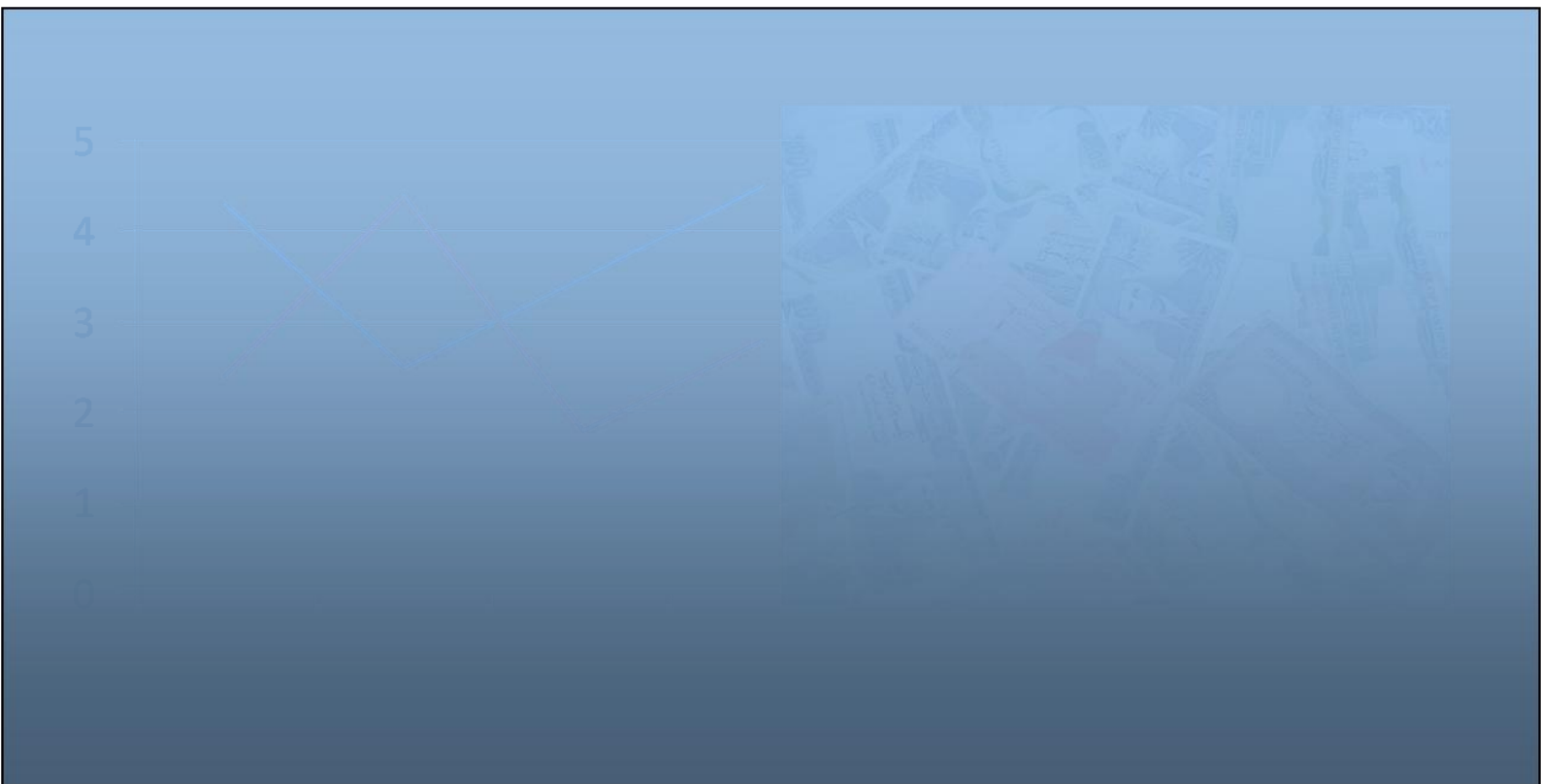
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Failed Take-Off: an Assessment of
Pakistan's October 2008 Economic
Crisis

Robert Looney

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Failed Take-Off: an Assessment of Pakistan's October 2008 Economic Crisis

Robert Looney¹

Introduction

Until the October 2008 economic crisis, the Musharraf government's economic policies were generally perceived to be a great success. In fact, Pakistan appeared to have one of the best economic growth records in its region. Based on these perceptions, there was widespread optimism that the country might finally break out of its post-independence cycle of boom and bust to achieve the type of high sustained economic growth that India has been experiencing since the early 1990s.

Prior to Musharraf, Pakistan's economy had underperformed, with per capita income growth averaging around 1% per annum during the 1990s. The civilian government of Benazir Bhutto and Nawaz Sharif had failed either to check corruption and cronyism or to efficiently use public financial resources to boost economic growth, contain poverty, and develop human resources. Instead, there was increasing political use of public resources, a bending of rules and regulations to benefit a select few, and erosion of institutional accountability². These factors led to high fiscal deficits; unsustainable domestic and foreign public debt; a sharp deterioration in the distribution of income, and a disturbing rise in the level of unemployment³ and poverty⁴.

The reforms introduced after the Musharraf administration seized power in October 1999 were clearly designed to address many of Pakistan's economic problems. In particular, they targeted the country's massive poverty, stagnant economic growth, deteriorating institutional framework and weak governance structures. Musharraf's regime embraced globalization, structural reforms, and opening the country to investment and trade. The results surprised even the general's most ardent supporters, as the size of the economy increased by almost 50 percent, with income per-capita up by nearly 25 percent. Cities and towns seemed to be booming, and the country managed to recover impressively from the devastating earthquake of 2005⁵. Toward the end of the Musharraf era:

¹ Robert Looney is a Professor at the Naval Postgraduate School, Monterey, California, US. The views expressed are entirely those of Professor Robert Looney and should not be construed as reflecting the views of the PSRU, Department of Peace Studies or the University of Bradford.

² See Hilton Root, "The Political Economy of State Failure," *The Milken Institute Review* Spring Quarter 2005, pp.65-74 and Robert Looney, "Pakistan's Economy: Achievements, Progress, Constraints and Prospects," in Hareez Malik, *Pakistan: Founder's Aspirations and Today's Realities* (Oxford: Oxford University Press, 2001) for a detailed description of this period.

³ Unemployment more than doubled during the 1990s. See Edward Gardner, "Wanted More Jobs," *Finance and Development*, 40:1 (March 2003) <http://www.imf.org/external/pubs/ft/fandd/2003/03/gard.htm>

⁴ Detailed in: *Poverty in Pakistan: Vulnerabilities, Social Gaps, and Rural Dynamics* (Washington: World Bank, October 28, 2002).

⁵ "Bread and Butter Politics," *The Guardian*, February 20, 2008.

- The economy grew at rates between 7.0% and 7.5%;
- The share of industry in GDP rose from 22.6% in 2000 to 26.7% in 2006;
- The annual percentage growth in industrial value added doubled;
- The share of gross fixed capital formation in GDP increased by three percentage points;
- The services sector posted an impressive performance, with annual growth of the value added in services nearly doubling over seven years, and
- The number of mobile phone subscribers rose to 82 in 1,000 people, up from 2 in 2000.

Yet by early 2008, the economy was clearly in trouble. It faced a rapid loss of foreign exchange reserves, mounting inflationary pressures and declining rates of growth. What had gone wrong?

Underlying Causes of the Crisis

While some analysts blame external factors, such as rising international commodity and oil prices, others argue that long-term domestic factors caused Pakistan's sudden economic collapse. Specifically, a body of analysis, here dubbed the "failed take-off school," suggests that the Musharraf economic strategy compounded many pre-existing structural problem, creating serious imbalances throughout the economy. These imbalances continue to destabilize Pakistan's economy and its society and are the source of much of the country's current violence and discontent.

The leading proponent of this school, Shahid Javed Burki, a former Minister of Finance and World Bank Vice President, argues that, despite early positive signs⁶, the Musharraf Government missed a golden opportunity to put the economy on a new growth path.⁷ While the administration's pro-business orientation unleashed considerable entrepreneurial activity, it was not accompanied by the on-going improvements in governance, economic freedom and financial reform necessary to complete the takeoff and achieve sustained growth and development⁸. Of particular importance were limited improvements and, in some cases, deterioration in the five key governance areas monitored by the World Bank: (1) voice and accountability, (2) political stability, (3) government effectiveness, (4) regulatory quality, (5) rule of law and (6) control of corruption⁹.

The government's economic strategy, together with the underdevelopment of institutional support,¹⁰ created an environment increasingly at odds with high rates of sustained economic growth. While the country was able to attract considerable amounts of more foreign investment, most of these funds went into import activities to satisfy domestic demand, instead of into the export sector. This pattern of investment placed increasing pressure on the balance of payments, making the country very vulnerable to external shocks and reductions in external capital flows.

⁶ Shahid Javed Burki, "Aspects of Economic Take-off," *Dawn*, June 14, 2005.

⁷ Shahid Javed Burki, "An Expansionary Budget," *Dawn*, June 21, 2005.

⁸ Jennifer Bremer and John Kasarda, "The Origins of Terror: Implications for U.S. Foreign Policy," *Milken Institute Review*, Fourth Quarter 2002, pp. 34-48.

⁹ Governance Matters 2007: Worldwide Governance Indicators, 1996-2006 (Washington: World Bank, 2007). http://info.worldbank.org/governance/wgi2007/sc_country.asp

¹⁰ Shahid Javed Burki, "Causes of the Crisis," *Dawn*, February 12, 2008. <http://www.dawn.com/2008/02/12/op.htm#1>

Pakistan's economic vulnerability is demonstrated by data on investments and their financing sources. While the rate of private investment increased by about a third, from 13.9% of GDP in 2001-02 to 18.0% in 2006-07, gross national savings declined from 19.0% of GDP to 18.7% during the same period.

In addition, the Musharraf administration failed to anticipate the supply bottlenecks, particularly in the areas of electricity and gas, which would inevitably result from a sharp increase in GDP. By 2006-7, energy shortages were forcing many firms to shorten hours and reduce output, and there was mounting concern that the power shortage would affect the productive capacity and export performance of the country. In all fairness to the Musharraf administration, the energy crisis was the result of long-term supply-side neglect. Beginning in the early 1980s, the gap between the consumption and generation of electricity had steadily expanded, but no augmenting measures were initiated¹¹. Not until very recently were the country's problems examined in any sort comprehensive way¹².

Next, the tax base remained narrow and rather inflexible. The Musharraf government failed to realize that major fiscal reforms were needed to pull wide segments of the population out of poverty and, thus, prevent growth from widening income inequalities¹³. Specifically, the income tax system was not adjusted. As a result, only about 2% of Pakistan's population paid direct income tax, while approximately 70% of tax revenue was generated by indirect taxes, which placed most of the tax burden on the poor, the salaried class and the business sector.

Not only did the poor pay more than their fair share of taxes, but they benefitted little from the Musharraf economic expansion. Much of the increase in GDP came from the sectors which returned high rewards to the investors but in which the share of wages was relatively low. Real estate development was one of the important sectors of the economy, as was the modern service sector. Neither, at least in the context of Pakistan, generated employment and income for the poorer segments of the population¹⁴.

Another area where the Musharraf administration failed to make any progress at reform was the country's sprawling military industrial complex or Milbus. Over the years, Pakistan's military had expanded its holdings of industries, properties and foundations. These properties guaranteed the armed forces both organizational autonomy and a regular flow of resources from the public and private sectors – often to the enrichment of senior officers, both active-duty and retired. It is estimated that the military controlled 12% of state land, or 11.58 million acres. Much of this land was rented at very low fees to military personnel. The estimated total wealth of this sector may have been as high as \$100 billion. From an economic perspective, these activities are nothing like the leading industries in Rostow's take-off stage. Instead,

¹¹ Zia-ul-Haq Sarhadi, "Need for a Viable Energy Policy," *The News, Business and Finance Review*, November 19, 2007.

¹² Robert Looney, "Energy and the Pakistani Economy: An Exploratory Analysis to 2035," in Robert Hathaway ed., *Fueling the Future: Meeting Pakistan's Energy Needs in the 21st Century* (Washington: Wilson Center, March 2007), pp. 93-104.

¹³ Oxford Analytica, "Pakistan: Much-Needed Tax Reform is Unlikely This Year," April 19, 2007.

¹⁴ Shahid Javed Burki, "The Economy Under Pervez Musharraf," *Dawn*, October 17, 2007

Milbus encouraged crony capitalism and inefficiency, placing a tremendous drag on economic expansion.¹⁵

Pakistan's underinvestment in human capital was another structural problem that had existed almost since independence. The problem was compounded by a rapid increase in population from 32 million in 1947 to 165 million in 2008. Even so, Burki argues:

“This increase in population could have been turned into an economic asset had a determined effort been made to invest in its development. This was not done. No government in Pakistan’s 60 year history made social and human development its priority. The consequence is that Pakistan today has a very large population which has low levels of literacy and very poor skill development¹⁶”.

In sum, Pakistan's current economic meltdown was precipitated by basic structural problems that have repeatedly interacted to create balance of payments crises. To begin with, the Pakistani economy is heavily dependent on imports. The country's imports always surpass its exports, many of which consist of traditional items of poor quality due to Pakistan's poor human capital development. Next, Pakistan's tax-to-GDP ratio is 10%, far below the average 17% of developing countries. Even more telling, less than two percent of the population is covered by the tax net. Thus, the Musharraf government's huge expenditures on debt servicing, defense and current spending resulted in fiscal deficits that reached 7.4% of GDP by FY2008¹⁷.

Simply put, Musharraf's policies made Pakistan dangerously dependent on foreign capital. The country's political instability and lack of significant progress in governance and economic reforms further increased its vulnerability to a fall-off in foreign capital. By 2007, it found itself in a position where any major reduction in foreign capital inflows would precipitate an economic crisis.¹⁸

In addition to this pre-existing set of structural conditions, specific economic policies pursued under President Pervez Musharraf helped trigger the October 2008 crisis¹⁹:

- High Consumption. Growth was based on a consumption-led strategy aided by generous aid inflows, rising asset prices and loose monetary policy;
- Inflation. A by-product of the high-consumption strategy was an extremely high inflation rate, which rose steadily after March 2007 to eventually reach 25%. While rising global food and oil prices exacerbated the trend, essential corrective measures – notably through tighter monetary policy – were delayed, and

¹⁵ Ayesha Siddiqa, *Military Inc.: Inside Pakistan's Military Economy* (London: Pluto Press, 2007), p. 242.

¹⁶ Shahid Javed Burki, “Causes of the Crisis,” *Dawn*, February 12, 2008

¹⁷ Iftikhar A. Lodhi, *Pakistan's Economic Crisis and the IMF Bailout Package*, Institute of South Asian Studies, ISAS Insights, No. 42, December 9, 2008, p. 3.

¹⁸ Shahid Javed Burki, “The Economy Under Pervez Musharraf,” *Dawn*, October 17, 2007

¹⁹ Oxford Analytica, “Pakistan: IMF rescue May Add to Instability Risks,” November 18, 2008

- Current account deficit. The current account deficit widened during the last three years of Musharraf's rule, as consumption growth was accompanied by a consistent growth in imports. This deficit was met with stable flows of remittances, aid and portfolio investment, together with strong export performance. However, excessive dependence on foreign capital inflows made the current account highly vulnerable.

These factors contributed to a slowing of growth in 2007. In most countries, the slowing of growth usually does not cause political problems, unless gains from previous growth have been inequitably distributed. Unfortunately, the Musharraf administration's pro-business policy bias, lack of democratic feed-back and authoritarian style of policy-making were also not conducive to equitable growth and broad-based development²⁰.

While no detailed studies of income distribution are available for the last several years of Musharraf's regime, Burki estimates that around 10 million Pakistanis benefitted from the economic growth and restructuring, 25 million would have entered the system had it not been disrupted, and 45 million were completely ignored²¹. Furthermore, he notes that regional inequality emerged from the Musharraf era, whose economic benefits were largely confined to the central and northern Punjab and large cities, such as Islamabad, Lahore, Karachi, Faisalabad and Gujranwala²².

The failed-takeoff school contends that Pakistan's political history suggests that economic developments can create great political instability. For example, there was a widespread perception that the benefits of the extraordinary economic expansion that occurred under President Ayub Khan in the 1960s went to a very limited number of prominent families²³. The authoritarian growth model that developed during this time created such a wide disparity of income between East and West Pakistan that it eventually resulted in the country's breakup. Similar, although less dramatic, changes took place in the late 1980s at the end of the Zia authoritarian era. In both these examples, the aggrieved resorted to violence to achieve their goals²⁴. Fortunately for Pakistan, they simply voted in 2008.

After the coalition government headed by the Pakistan Peoples' Party assumed power in February 2008, wrangling over cabinet appointments left the finance and economy post unfilled for successive months. The failure to take corrective measures exacerbated the crisis²⁵:

- Fiscal shortfalls. The global spike in oil prices increased the share of oil to 38% of the total import bill for the twelve months ending July 2008, as compared to 30% for the same period the previous year. In the July–October quarter alone, the oil import bill was 35% higher than for the same period the year before. However, this increase was not passed on to consumers, which resulted in higher spending on subsidies. Rising oil prices, together with

²⁰ Shahid Javed Burki, "Arithmetic of Discontent," *Dawn*, December 11, 2007.

²¹ Shahid Javed Burki, "Reaching the Disadvantaged," *Dawn*, December 18, 2007.

²² *Ibid.*

²³ Root, *op. cit.* p. 68.

²⁴ Shahid Javed Burki, "Analysing Political Violence," *Dawn*, September 18, 2007

²⁵ Oxford Analytica, "Pakistan: IMF rescue May Add to Instability Risks," November 18, 2008

higher public sector spending, raised the budget deficit to more than 75% of GDP.

- State Bank of Pakistan borrowing. To meet the financing gap, the government made use of large-scale borrowing from the State Bank of Pakistan (SBP). Between June 1 and November 8, 2008, new borrowing totaled 4.6 billion dollars, which both increased government debt and inflationary pressures.
- External deterioration. Slippages on the external account also continued. Even as the import bill increased, foreign exchange reserves dwindled due to falling portfolio inflows. The country witnessed massive capital flight in September, October and November, pushing the currency downwards and fuelling expectations of default.

Crisis Management

Plan A²⁶. In September and October 2008, Pakistan sought assistance from a number of sources, including the Asian Development Bank (ADB), the World Bank, The United Kingdom's Department for International Development (DFID), and the Islamic Development Bank (IDB)²⁷. The ADB agreed to provide Pakistan with a \$500 million loan, "to address harm done to poor families and the country's economy by unprecedented international fuel price hikes²⁸." In addition, the World Bank originally offered \$1.4 billion in assistance²⁹. However, the combined ADB and World Bank loans were insufficient to address Pakistan's balance of payments shortfall.

Plan B. Pakistan next attempted to secure direct commitments from national governments. In the fall of 2008, a group of nations met President Zardari to discuss ways to aid Pakistan with its political, economic and security problems. Calling themselves the Friends of Pakistan, the informal coalition contained representatives from 11 nations, including China, Saudi Arabia, and the United States, as well as the European Union, the United Nations and the IMF. While Zardari reportedly sought \$100 billion in aid, he left his two meetings with the group with no commitment of financial support³⁰.

Zardari also traveled to Saudi Arabia in search of funding. Saudi Arabia was reportedly asked for up to \$6 billion in deferred payments for petroleum imports³¹, which would free up capital to pay other international obligations. Apparently, the Pakistani government felt that, if the deferral was granted, IMF assistance would not be required. However, the visit ended with no public announcement of Saudi support. In general, recent Saudi relations with Pakistan had been cool for several reasons, including Pakistan's quest for an oil facility in Iran.

²⁶ The events of October and November 2008 draw heavily on Michael Martin and K. Alan Kronstadt, *Pakistan's Capital Crisis: Implications for U.S. Policy* (Washington: CRS Report for Congress, November 21, 2008).

²⁷ Mubarek Zeb Khan, "\$4.5 Billion Needed Within 30 Days to Build Up Reserves: Recourse to IMF Last Option," *Dawn*, October 23, 2008.

²⁸ "ADB Provides Pakistan with \$500 Million to Accelerate Economic Transformation," ADB press release, September 30, 2008.

²⁹ "WB to Give Pakistan \$1.4 Billion This Year," *Daily Times*, October 13, 2008.

³⁰ Nissar Hoath, "UAE to Host Pakistan Bailout Talks Next Month," *Emirates business* 24/7, October 27, 2008

³¹ Baqui Sajjad Syed, "Zardari's Saudi Visit Part of Attempt to Avoid IMF Loan," *Dawn*, November 4, 2008.

China, historically a friend of Pakistan with huge foreign reserves, also declined to make any major cash infusion. President Zardari's October 2008 China visit yielded only US\$500 million, together with promises of future investment and trade opportunities. Clearly, China was concerned with its own economy, which faced a major decline in exports due to the global recession. The Chinese also noted that they were "no longer inclined to grant cash outright without structural reforms from the receiving government"³².

Finally, the United States was critical of Islamabad's commitment and capacity to fight militants engaged in insurgency against US-led forces in Afghanistan. Past failure of U.S. aid programs to Pakistan added to its reluctance to fund a major bail-out. Instead, the United States threw its weight behind the Friends of Pakistan group, which reportedly required Pakistan to get an IMF loan approval to insure careful management of the economy and provide greater investor confidence. In turn, the group would aid Pakistan in developing a comprehensive and coordinated approach to its security, development and institutional issues.

Plan C. Lacking other funding sources, Pakistan had little choice but to formally request IMF assistance, an action that was clearly the last resort. Pakistan's reluctance to accept formal IMF help was due both to the country's history of poor relations with the Fund³³ and the likelihood that the Fund's usual austerity measures would result in a marked economic slow-down and increased unemployment. Nonetheless, by November 15, 2008, Pakistan had reached a tentative agreement with the IMF to borrow \$7.6 billion over 23 months³⁴.

While the IMF package will significantly help to reassure investors that Pakistan's government is committed to a path of prudent economic policy, it will bring near-term economic distress to the country and pose major implementation difficulties. In general, the package is based on locking into place key policy commitments, which include cutting the budget deficit; increasing the tax-GDP ratio; removing fuel subsidies; revising interest rates upwards to fight inflation, and promising not to borrow from the SBP. The fiscal and monetary tightening come at a time when other Asian economies are boosting government spending, loosening monetary policy and cutting taxes to support growth as external markets contract due to the global recession – a luxury the Pakistan can no longer afford³⁵.

³² Jane Perlez, "Rebuffed by China, Pakistan May Seek IMF Aid," *New York Times*, October 19, 2008.

³³ Robert Looney, "Failed Economic Take-Offs and Terrorism in Pakistan: conceptualizing a Proper Role for U.S. Assistance," *Asia Survey* 44:6 (November/December 2004), pp. 771-793.

³⁴ Details of the IMF program can be found in *Pakistan: Request for Stand-By Agreement—Staff Report* (Washington: International Monetary Fund, December 2008). Pakistan's revised intentions under the program are outlined in: Pakistan: Letter of Intent, Supplementary Memorandum on Economic and Financial Policies and addendum to the Technical Memorandum of Understanding (Washington: International Monetary fund, March 16, 2009).

³⁵ For an overview of the country's macroeconomic dynamics see: Jesus Felipe and Joseph Lim, *An Analysis of Pakistan's Macroeconomic Situation and Prospects* (Manila: Asian Development Bank, December 2008).

Assessment

Pakistan's structural problems and policy miscalculations have combined to create a vicious circle that will be extremely difficult to reverse. While exogenous price shocks played a role, the country's current inflationary pressures largely resulted from increased government borrowing from the SBP over the last several years. However, measures like revoking subsidies and increasing sales tax, required under the IMF program to arrest the growing fiscal deficit, may fuel inflation further. The large external account deficit and the slowdown of capital inflows in response to increased internal instability are also exerting downward pressure on the Rupee³⁶. The net effect of the Rupee's depreciation in a high-inflation environment has been to exacerbate price increases by raiding import costs. At the same time, reduced demand due to the world recession could curb Pakistan's export growth throughout 2009 and into 2010.

The results of this vicious circle of inflation-Rupee devaluation, rising costs and lost competitiveness are likely to be continued lower than expected revenue generation and higher than anticipated current account deficits. While an expanded U.S. aid program may dampen these forces, it is unlikely the U.S. will underwrite a painless transition³⁷.

The economic impact of Pakistan's defense expenditures reinforces this vicious circle. In countries with weak institutional foundations—especially in areas of governance, like voice/accountability; political stability; government effectiveness; regulatory quality; rule of law, and control of corruption—increasing defense expenditures beyond a certain threshold will likely lower the rate of economic growth. According to the World Bank, Pakistan ranks well below the 50th percentile in all these areas when compared to other countries. As a result, empirical research³⁸ suggests that the increases in Pakistan's already high defense expenditures required by the deteriorating security situation will strain the economy and likely result in increased corruption, government inefficiency and the crowding out of private sector activity.

The continued deterioration in fiscal and external accounts suggests that Pakistan will experience several more years of slow economic growth before its economy again expands at rate of 6% and above. In the meantime, because of the country's continued current account deficit and inability to attract substantial capital inflows, it will require further injections from the IMF and other donors simply to prevent a new balance of payments crisis. Unfortunately, the ongoing IMF program will be confined largely to treating the symptoms of Pakistan's boom-and-bust pattern of growth. There will be few funds available for alleviating the fundamental causes of Pakistan's economic plight—low rates of human capital, energy/infrastructure shortfalls, and institutional underdevelopment.

³⁶ The Pakistan rupee depreciated by 13.7% against the US dollar in 2008, reflecting investors' fears of poor political prospects, rising prices and slowing economic growth. However, the rate of depreciation slowed following the finalization of the IMF package, falling to 7.3% quarter on quarter in the fourth quarter of 2008, from 12.8% in the third quarter.

³⁷ As of early April 2009 the U.S. congress was still debating the President's proposed \$2.8 billion aid package for Pakistan.

³⁸ Robert Looney and Robert McNab, "Pakistan's Economic and Security Dilemma: Expanded Defense Expenditures and the Relative Governance Syndrome," *Contemporary South Asia* 16:1 (March 2007), pp. 63-82.

Pakistan's process of macroeconomic adjustment will prove lengthy and difficult, while increasing economic distress among ordinary citizens. Will the process set up a repeat of the economic malaise of the 1990s? Will the country be forced to reduce its defense expenditures for the sake of economic stability and job creation? If so, what happens to the security situation? Could deteriorating conditions result in a collapse of the civilian government? Clearly the situation is dire, and the next few years will be trying ones for the country.